T. Rowe Price®

U.S. Economic Perspective

March 2002

What's Inside This Issue

- **Review & Outlook**

The recession that began last March appears to have ended in January, and expansion is taking hold. Corporate cost cutting has improved profit margins, and the end of the inventory liquidation cycle is bolstering production and employment trends. Rising profits and utilization rates are spurring a capital spending revival, and renewed employment gains bolster consumer spending trends. The demand rebound gives the recovery staying power that justifies a shift toward a more neutral monetary policy stance.

- **Monthly Focus**

Household debt service burdens are unlikely to derail recovery. The share of income allocated to principal and interest payments is just short of its 1986 record, but the associated growth of net worth has been far greater than in the early 1980s. While the accumulation of housing wealth has bolstered the principal portion of debt service, the burden of interest payments is clearly lower than it was 15 years ago.

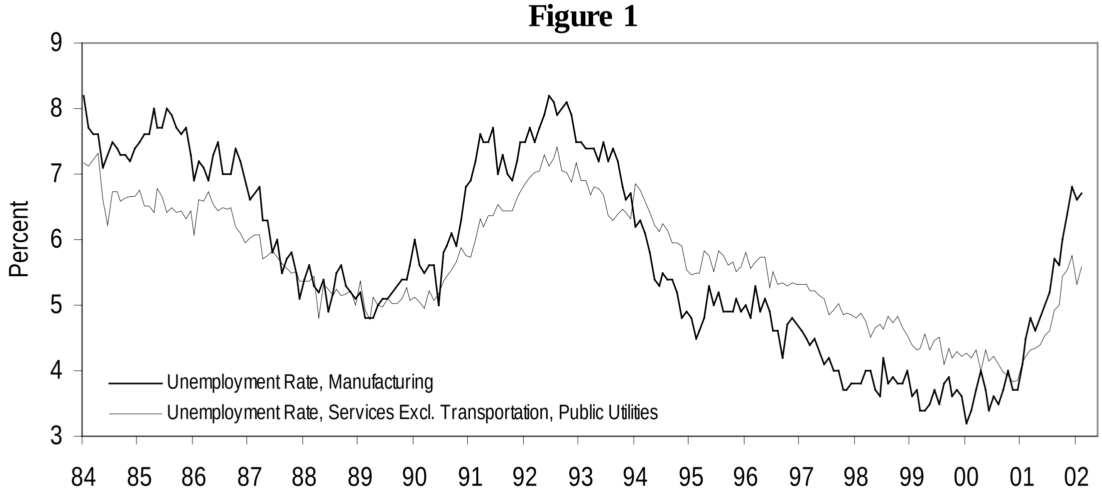
Review and Outlook

A Recovery With Staying Power

The recession that began last March appears to have ended in January, and recovery is gathering momentum. Product and labor market trends are improving as an unprecedented cycle of inventory liquidation reverses course. Stimulative monetary and fiscal policies have hastened private sector balance sheet repair and reduced borrowing costs. The stage is set for an ongoing rebound in final demand, with business investment leading the way and consumer spending following faithfully the employment-based improvement in income growth.

An investment recovery at this phase of the cycle should come as no surprise. Improving corporate cash flow provides the means, and the rebound in production provides the motive. Even at low rates of capacity utilization, the industrial and business investment cycles are virtually coincident. As production expands in the early stages of economic recovery, plant & equipment outlays must be raised quickly from recession levels in order to prevent too rapid an absorption of available capacity. The capacity-investment connection may be even stronger

Recession Generated Relatively Little Service Sector Slack
Figure 1



Source: Bureau of Labor Statistics, TRPG Calculations, Haver Analytics

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in the service sector, which accounts for ¾ of all business investment. Even at the recession trough, available measures of service sector slack failed to breach 1995's soft landing levels (Figure 1, page 1).

Purchases of high-tech equipment are generating the strongest impulse to the investment recovery. Strong productivity growth throughout the recession affirmed the business sector's persistent emphasis on innovation, information and flexibility. Last year's 0.7% decline in outlays for computers & software contributed significantly to corporate sector balance sheet repair, but also appears to have generated a sharp deceleration in the rapidly depreciating high-tech capital stock (Figure 2). The technology-based imperatives of the "new economy" argue strongly for continued strong growth in the stock of computers & peripherals, and ever-shortening asset lives mean that a mounting commitment to gross investment is required to sustain expansion of the net capital stock.

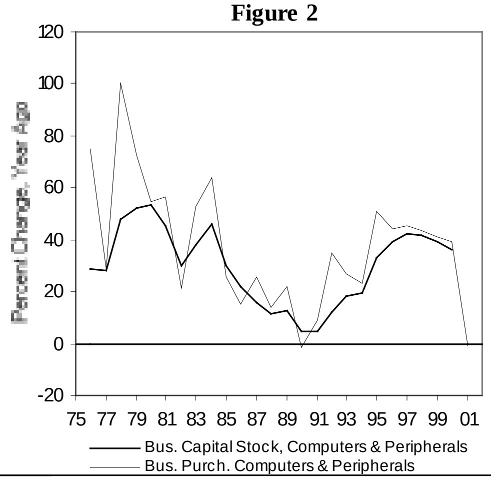
While pent-up demand for technology goods spurs a capital spending rebound, the lack of pent-up "big-ticket" consumer demand raises questions about the magnitude of consumers' contribution to recovery. The scope for a typical early-recovery boom in vehicle and home sales is restricted by the absence of a typical recessionary bust, but any slide in demand in response to rising interest rates is likely to be relatively mild. Secular trends toward lower inflation and interest rates, and toward a faster pace of financial innovation have generated a lasting reduction in the volatility of demand in these interest-sensitive sectors (Figure 3) and have increased consumers' debt capacity (Monthly Focus, page 3).

This demand recovery, together with an upswing in the inventory cycle, is generating the ripple effects that imbue economic expansion with internal momentum. Demand gains elicit a production response, which requires additional hiring, generating income fuel for further rounds of spending growth. Rising utilization rates and corporate profits encourage and facilitate growing capital spending commitments. It all adds up to 3.5% - 4.0% real GDP growth over the course of 2002, with the contribution from final demand increasing as the year progresses.

The "new economy" composition of the demand rebound does not change the Fed's cyclical mission. If unchecked, the stimulative monetary policy stance conveyed in a near-zero inflation-adjusted federal funds rate would eventually spur demand beyond the economy's sustainable supply potential, fueling inflation pressures. In this light, the coming shift to a neutral policy stance, consistent with the funds rate in a 4.5% - 5.5% range, will not threaten the recovery, but improve prospects for sustainable expansion.

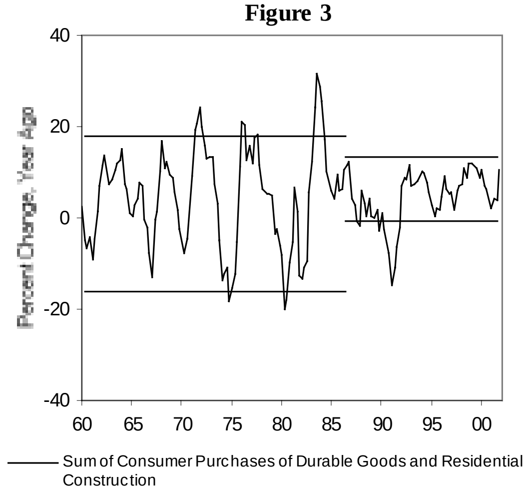
Beyond the cyclical turn, "[m]onetary policy will have to be particularly sensitive to the possibility that the resiliency our economy has exhibited during the past two years signals subtle changes in the way our system functions" (Greenspan, March 8, semiannual monetary policy report to the Congress). These changes manifest themselves in a less volatile cycle around a productivity-enhanced growth potential. This lower risk, higher return profile for the U.S. economy would merit lower risk premiums and higher real interest rates.

Businesses Arrest Expansion of Computer Capital Stock
Figure 2



Source: Bureau of Economic Analysis, Haver Analytics

Big-Ticket Consumer Goods Settle Down
Figure 3



Source: Bureau of Economic Analysis, TRPG Calculations, Haver Analytics

Monthly Focus

No Balance Sheet Impediment to Consumer Recovery

An elevated household debt service burden – the percentage of disposable income allocated to periodic payments of interest and principal – is often cited as a risk to the staying power of the unfolding consumer recovery. The argument is that a higher share of income diverted to fulfillment of previously incurred obligations reduces funds available for present consumption.

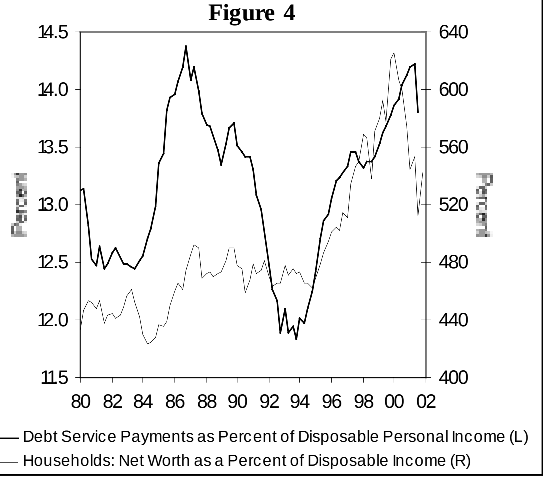
These fears are overblown. As an immediate matter, the period of most intense pressure appears to have passed. In response to lower interest rates and slower growth in interest-financed purchases, the growth rate of interest and principal payments slowed last year, contributing to a peak in the debt service burden.

Beyond these observations, proper assessment of the implications of a rising debt service burden must include reference to the asset side of the household balance sheet. The 1990s rise in debt service is financing a far greater buildup of assets than was the case in the late-1980s cyclical debt service buildup. Since wealth underpins consumers' financial wherewithal, a rising debt burden is less ominous when it is associated with an increase in net worth. Even after the 2000-2001 plunge in equity portfolio values, household net worth at 5–5.5 times disposable income remains in a different realm than the 4.7 multiple that prevailed in the post-War period through 1994 (Figure 4).

These developments are linked significantly to the sustained strength in the housing market. Low interest rates and declining transaction costs have raised housing affordability and encouraged homeownership. The homeownership rate rose to nearly 68% last year from 64% in 1994. (In contrast, the homeownership rate slipped fractionally while the debt service burden mounted during the 1983-1986 period.) An increase in debt service driven by a shift toward owner-occupied housing does not crimp overall consumer spending. It merely reflects the shift toward principal and interest payments, which are included in debt service calculations, and away from rental payments, which are not.

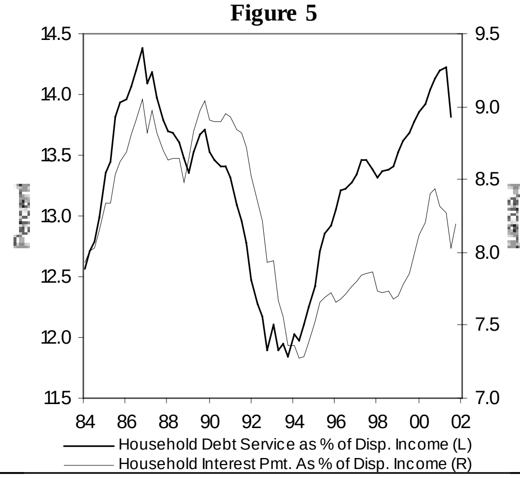
Finally, for a given loan size and repayment schedule, a lower interest rate environment increases the pace at which principal is repaid. If principal is a greater portion of the monthly payment, then the burden of interest payments – a better measure of dollars diverted from current consumption– is lighter than the broader measures of debt service would suggest. Where overall debt service at its 2001 high nearly equaled its 1986 peak, the interest payment portion of that burden retraced only about half of it's early 1990's decline, leaving it comfortably below the previous cyclical peak (Figure 5).

Consumer Return on Debt Improves in the 1990's
Figure 4



Source: Federal Reserve Board, Haver Analytics

Emphasis on Principal Payment Reflect Asset Growth
Figure 5



Source: Federal Reserve Board, TRPG Calculations, Haver Analytics

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